The politics of denial

By Jan Dehn

A politics of denial now governs decision-making in developed economies. It relies on a two-pronged strategy of postponement and scapegoating, but if allowed to go unchallenged may end up having far more serious consequences than merely victimising the least powerful in society. All stages of the politics of denial are already on display to various degrees across the developed world today with clear similarity to the politics in the aftermath of the Great Depression in the 1930s. The ultimate destiny of the new politics is failure, but the death struggle may be long and could be violent. It is bad for investment in developed countries and it may have adverse consequences for EM too. However, current valuations, proven resilience and strong technicals suggest that EM assets will hold up in the face of the shocks arising from developed economies as they sink ever deeper into the twisted logic driving the politics of denial today.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.3	–	0.17%
MSCI EM Small Cap	11.5	–	0.20%
MSCI Frontier	9.2	–	-2.05%
MSCI Asia	11.7	–	0.52%
Shanghai Composite	11.9	–	1.59%
Hong Kong Hang Seng	6.8	–	0.59%
MSCI EMEA	9.8	–	-2.74%
MSCI Latam	13.0	–	2.38%
GBI-EM-GD	6.28%	–	1.00%
ELMI+	3.87%	–	-0.13%
EM FX spot	–	–	-0.09%
EMBI GD	5.38%	388 bps	1.19%
EMBI GD IG	4.02%	246 bps	1.60%
EMBI GD HY	7.29%	590 bps	0.72%
CEMBI BD	5.29%	395 bps	0.53%
CEMBI BD IG	4.05%	272 bps	0.77%
CEMBI BD Non-IG	7.34%	599 bps	0.12%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.8	–	-0.65%
1-3yr UST	0.57%	–	0.40%
3-5yr UST	0.96%	–	0.97%
7-10yr UST	1.41%	–	2.17%
10yr+ UST	2.21%	–	4.86%
10yr+ Germany	-0.13%	–	4.97%
10yr+ Japan	-0.25%	–	1.61%
US HY	7.27%	594 bps	-0.43%
European HY	5.01%	550 bps	-1.00%
Barclays Ag	–	240 bps	1.00%
VIX Index*	15.74	–	-10.02%
DXY Index*	95.86	–	0.42%
EURUSD	1.1107	–	-0.09%
USDJPY	102.51	–	0.28%
CRY Index*	192.57	–	-0.95%
Brent	49.4	–	2.11%
Gold spot	1334	–	1.42%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

A new kind of politics

A politics of denial now governs decision-making in developed economies. They do not say so explicitly, but political leaders in developed economies understand only too well that there is an enormous price to be paid to fix their economies from the excesses that led to the Developed Market Crisis (DMC) of 2008/2009 and its aftermath. Developed countries face significant debt overhangs, unfunded pension deficits and the growing future health liabilities of ageing populations, while their productivity is declining. The reforms to fix all this would extract an almost insurmountable political cost. The politics of denial is designed deliberately to avoid this political cost for as long as possible.

To this end, politicians are employing a two-pronged strategy of postponement and scapegoating. Postponement is most clearly evident in the extreme imbalance between stimulus and reforms in developed economies. Since the DMC was first and foremost a debt crisis, the rational policy response should have emphasised aggressive deleveraging, better regulation and productivity enhancing reforms – with monetary policy only playing a supportive role during tough reforms. In reality, however, monetary policy easing has been elevated to the be-all and end-all, while practically nothing has been done to raise productivity and cut the debt overhang. Regulation has been recruited into the service of financial repression rather than used to improve asset allocation.

Scapegoating is now becoming far more visible and important within the politics of denial. As successive acts of postponement become ever less effective without actually curing any of the underlying economic problems, voters are increasingly experiencing stagnation. They are getting angrier. Their discontent is made

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worse by the excessive reliance on asset purchases by central banks, which skews income distributions even more. Scapegoating is rising in importance, because it helps to divert the rising voter anger towards less powerful groups, while giving the impression of action and helping to obfuscate the real underlying problems. Left and Right only differ in their choices of preferred scapegoats. The Left likes to victimise the wealthy, business owners and entrepreneurs, while the Right prefer to targets benefit recipients, unions and foreigners.

Gloomy outlook

Unfortunately, the politics of denial may, if allowed to go unchallenged, end up having far more serious consequences than merely victimising the least powerful in society. Unchecked, politics will logically progress through four stages that ultimately end up in a far uglier place that we see today. Specifically, the politics of denial imply a four stage pathway of demise:

- Stage 1 – The decline of mainstream politics: The destruction of mainstream politicians is already well underway across the Western world with the resignation of British Prime Minister David Cameron the latest manifestation. Mainstream politicians are being jettisoned in favour of populists for two reasons. First, they have failed to implement effective economic remedies in the aftermath of the crisis. Second, they are not nearly as good at scapegoating as the populists, who are now gaining ground at their expense.

- Stage 2 – The rise of populism: Populist rule will be defined by (a) scapegoating becoming a mainstay of politics and (b) the underlying economic problems get even worse due to deterioration in the quality of policy. Scapegoating itself may accelerate the pace of economic decline, say, if immigrants are forcibly repatriated. The economic decline ultimately undermines populist rule as voters lose faith not just in the populists, but also in democracy itself.

- Stage 3 – Authoritarianism: The lure of authoritarian governments is their ability to act decisively, holding up the promise of curing the failures of ineffective mainstream and populist governments. Yet, to be effective the authoritarian state must usurp powers from all spheres of private life from the economic through security to the media. Such a draconian centralisation of power requires a strong nationalistic rhetoric and more severe repression. Since the scope for scapegoating within the domestic economy is gradually getting exhausted it follows that scapegoating must increasingly look to targets overseas. Hence, nationalistic authoritarian governments increasingly come into conflict with other countries.

- Stage 4 – War: The explicit objective of policy during this phase is to blame the crisis on foreigner interests as the scope for credibly scapegoating at home is exhausted. Policies of economic nationalism, such as competitive devaluations, trade protection, expropriation of foreign companies, etc. become widespread. Countries with global reserve currencies are significantly better placed to conduct this kind of economic warfare due to captured demand for their currencies and bonds among central banks. International tensions rise and will, in extremis, result in conventional war.

Echoes of darker times

The politics of denial clearly has echoes to the politics in the aftermath of the Great Depression in the 1930s. Then, as now, powerful political forces are being fuelled by anger. Nationalism is on the rise in the US, Europe and Japan, and there is a longing for more stable and safer societies. This desire is likely to morph into calls for a stronger and more interventionist state to deal with economic uncertainty, income inequality and perceived threats from abroad. Similar desires led to Roosevelt's New Deal and the rise of Communism and Fascism across Europe in the 1930s.

Bad for investment

For now, however, the politics of denial is still in a relatively early stage, though it may progress further. The politics of denial already manifests itself clearly in the near-complete control of financial markets via QE policies and regulation. It also manifests itself in the sharply rising sentiment against immigration and refugees in Europe and in Donald Trump's proposal to build a wall along the border to Mexico. It manifests itself in the platforms of US presidential candidates, which now promise to unwind free trade agreements. And most recently it has manifested itself in the UK's Brexit vote.

But if current political tendencies continue investors should, at a minimum, think beyond the current symptoms. At a minimum, recent trends of declining productivity, the stubborn absence of a strong economic up-turn, rising inequality and growing discontent among ever larger swathes of the population will continue. There will be yet more decisions, such as Brexit, that fly directly in the face of economic logic.

Ultimately, the politics of denial brings societies closer to crisis and may yet become the single largest source of shocks to economic, political and financial life. And almost all of these shocks will emanate from developed economies, where the politics of denial is most pronounced.

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In the final equation, the politics of denial ends in failure. Postponements of necessary adjustment eventually become ineffective, while the underlying problems finally become too big. Scapegoating eventually ends up becoming unacceptable as it extends its ugly tentacles deeper and deeper into mainstream society itself. A new and larger crisis materialises, but within this final and spectacular collapse of this particular brand of politics lie buried the seeds of a more sustainable politics which is based on more rational, time-consistent policies.

Not quite the sound of inevitability

While it is worrisome that all of the stages of the politics of denial are already on display to various degrees across the developed world today, there is a silver-lining. There is nothing inevitable about the process nor do the stages necessarily have to occur in the precise order listed above. Denial may give way to reckoning. Technocrats may in the end be more active than politicians. Populations may learn from their mistakes. Rajoy's victory over far more leftist extremist forces in Spain last week is a case in point. Perhaps most importantly, if economies perform better than expected the support for populists will eventually wane.

What about EM?

EM countries have their fair share of populists, but they often fail to hold on to power for very long. There are two main reasons for this. One is that EM countries typically are not afforded the luxury of running counter-cyclical policies. Developed economies tend to respond to economic problems with stimulus rather than reform. This is not possible in most EM countries, wherefore such ultimately unsustainable practices are often not available. The other reason is that most people in EM countries live very close to the poverty line without means to ameliorate the consequences for their livelihoods of violent business cycles. Hence, bad policies not only tend to be punished quickly in the markets, but also tend to be punished quickly by electorates. This is actually a good thing, especially for investors in EM assets, because governments are forced stay close to the straight and narrow.

The politics of denial is therefore mainly a developed market phenomenon. Still, what happens in developed markets clearly impacts EM ambiguously. The current starting point is not too bad for EM. After years of QE policies that deliberately subsidised developed markets at the expense of EM asset prices, EM are now dramatically more attractively valued than developed market assets. Moreover, despite sharp deterioration in sentiment towards the asset class, EM countries actually emerged largely unscathed from the quadruple shocks of the Taper Tantrum, the Dollar rally, the commodity price collapse and the start of the Fed hiking cycle. For example, default rates have remained low and there have been very few balance of payments crises or other serious threats to the ability and willingness to pay in the majority of EM countries. Looking back, it seems that is was mainly investors, who lost their cool.

Still, years of QE have left many institutional investors very long developed market assets, which is not exactly a comfortable place to be. Investors are rightly nervous, which may, ironically, deter some from putting money into EM immediately. However, we expect the relative investment proposition in favour of EM is now so strong that investors will eventually capitulate. A resulting flow back into EM, even if gradual, should be good for EM markets.

The power of technicals

EM is likely to be relatively insulated from the fallout arising from the problems in developed economies, even during bouts of volatility. This has been the pattern this year and it is mainly due to technicals, which are now very strong. Recall that investors have scaled back exposure to EM for nearly half a decade; there are very few sellers left. The power of technicals has been evident this year, where EM has performed well despite two major global shocks – expected Fed hikes and Brexit – that under different circumstances could typically have triggered drawdowns. Instead, EM asset classes have outperformed developed markets. EM local currency bonds, for example, which is surely one of the most under owned asset classes in the investment universe, is up double digits in Dollar terms this year versus low single digit returns for US bonds markets of similar duration. EM currencies are outperforming the US dollar.[1]

Don't forget the long-term

Ultimately, we expect developed economies to escape their debt and productivity challenges mainly by means of inflation and devaluation. This bodes well for growth in EM countries, because declining QE currencies will channel capital back into EM. While some EM exporters may find it challenging to cope with stronger currencies the majority of EM countries readily reform when required to do so. Others, such as China, are far more proactive, reforming well ahead of time. They will emerge as the big winners of tomorrow.

[1] To see why we anticipated EM's outperformance this year see *"Fixed income outlook 2016"*, The Emerging View, January 2016.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	4.08%	6.52%	-11.75%	-1.24%	-3.46%
MSCI EM Small Cap	2.55%	1.42%	-12.58%	0.24%	-1.99%
MSCI Frontier	-3.45%	-0.50%	-12.02%	0.86%	1.30%
MSCI Asia	2.75%	2.23%	-11.75%	2.33%	0.32%
Shanghai Composite	1.14%	-16.50%	-30.18%	16.53%	3.58%
Hong Kong Hang Seng	3.51%	-6.46%	-29.98%	1.58%	-3.41%
MSCI EMEA	3.45%	11.73%	-13.76%	-5.57%	-6.92%
MSCI Latam	11.46%	25.66%	-7.34%	-8.04%	-9.92%
GBI EM GD	6.15%	14.30%	2.24%	-3.48%	-2.18%
ELMI+	2.53%	5.81%	-1.04%	-3.03%	-2.91%
EM FX Spot	3.47%	5.27%	-6.77%	-9.84%	-9.12%
EMBI GD	3.37%	10.31%	9.79%	7.18%	6.45%
EMBI GD IG	3.56%	10.22%	8.38%	6.60%	5.64%
EMBI GD HY	3.16%	10.25%	11.54%	7.91%	7.62%
CEMBI BD	1.79%	7.80%	5.30%	5.68%	5.36%
CEMBI BD IG	1.79%	6.36%	5.40%	5.79%	5.56%
CEMBI BD Non-IG	1.78%	10.29%	4.80%	5.23%	5.01%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.26%	3.84%	3.98%	11.61%	12.08%
1-3yr UST	0.69%	1.65%	1.53%	0.85%	0.75%
3-5yr UST	1.66%	3.79%	4.22%	2.80%	2.15%
7-10yr UST	3.20%	7.71%	9.78%	5.46%	5.69%
10yr+ UST	6.85%	15.62%	20.77%	11.01%	11.25%
10yr+ Germany	6.91%	17.95%	21.38%	13.30%	13.08%
10yr+ Japan	2.99%	16.73%	21.75%	10.67%	8.14%
US HY	0.60%	8.71%	1.33%	4.07%	5.85%
European HY	-0.57%	3.73%	2.73%	6.71%	8.93%
Barclays Ag	1.83%	6.53%	7.06%	5.29%	5.42%
VIX Index*	0.70%	-13.56%	-2.18%	-3.85%	-0.82%
DXY Index*	-0.29%	-2.81%	-0.46%	15.42%	28.94%
CRY Index*	0.00%	9.33%	-14.05%	-30.70%	-42.81%
EURUSD	0.01%	2.26%	0.49%	-14.98%	-23.54%
USDJPY	-0.67%	-14.73%	-16.77%	2.86%	26.82%
Brent	-0.50%	32.59%	-20.29%	-52.01%	-55.78%
Gold spot	0.95%	25.76%	14.17%	6.54%	-10.29%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.

Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns. Data as at close of business 30 June 2016. Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

Ashmore

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 347 0649

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Istanbul
T: +90 212 349 40 00

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
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